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Payday Lending

Michael A. Stegman

A "payday loan" is a short-term loan made for seven to 30 days for a small amount. Eighty percent of all payday loans across the country are reportedly less than $300. Fees charged on payday loans generally range from $15 to $30 on each $100 advanced. Thus, a typical example would be that in exchange for a $300 advance until the next payday, the borrower writes a postdated check for $300 and receives $255 in cash—the lender taking a $45 fee off the top. The lender then holds on to the check until the following payday, before depositing it in its own account. Qualifying for a payday loan doesn't require a credit check, the application is simple, and the entire transaction can take less than an hour. All that a prospective borrower typically needs is a home address; a valid checking account; a driver's license and Social Security number; a couple of pay stubs to verify employment; wages and pay dates; and minimum earnings of at least $1,000 a month.[1]

Payday loans are not typically offered by depository institutions, but rather "provided by stand-alone companies, by check cashing outlets and pawn shops, through faxed applications to servicers, online, and via toll-free telephone numbers" (Robinson, 2001; see also Said, 2001). Virtually no payday loan outlets existed 15 years ago, but industry analysts estimate there are now as many as 22,000 of them (Bair, 2005). Today, there are more payday loan and check cashing stores nationwide than there are McDonald's, Burger King, Sears, J.C. Penney, and Target stores

[1] For examples, see the links at <http://www.fastfind.com/Loans/PaydayLoans.aspx>.

■ *Michael A. Stegman is Director of Housing and Policy at the John D. and Catherine T. MacArthur Foundation, Chicago, Illinois, and Duncan Macrae '09 and Rebecca Kyle MacRae Professor of Public Policy, Planning, and Business, Emeritus, at the University of North Carolina, Chapel Hill, North Carolina. His e-mail address is ⟨mstegman@macfound.org⟩.*

combined (Karger, 2005). Industry sources estimate more than a six-fold growth in payday loan volume in the last few years, from about $8 billion in 1999 to between $40 and $50 billion in 2004 (Murray, 2005). In 2004, payday lending generated an estimated $6 billion in finance charges (*USA Today*, 2004).

When the fee for a short-term payday loan is translated into an annual percentage rate (APR), the implied annual interest rate ranges between 400 and 1000 percent (Snarr, 2002). In addition, it is fairly common for payday loans to be rolled over into the next time period for an additional fee, and thus the fees are often paid several times during a year. These high implicit interest rates have led to complaints that payday lending is *per se* a predatory lending practice. While predatory lending has no "official" definition, it generally refers to lending practices "that are considered to be so detrimental to borrowers as to be considered abusive" (Quercia, Stegman, and Davis, 2004). Policymakers, especially at the state level, have responded with an increasingly strict regulatory regime. The payday loan industry has evolved in response.

For economists, several interesting issues arise in the study of payday loans. First, are payday loans just a situation in which willing customers and firms interact in the market for ready access to high-cost, short-term credit? Or does the payday loan industry encourage habitual borrowing and the snowballing of unaffordable debt in such a way that the state has a role to play in limiting consumers from their own excesses? Similar issues have been debated among economists for centuries, going back to the debates over usury. A related issue is whether an outright ban on payday lending or restrictive regulations that make payday lending unprofitable would curtail unnecessary borrowing or would force households to go underground to meet their emergency credit needs, thus reviving the market for loan-sharking. Another set of issues involves the potential interactions of mainstream banks and payday lending. Given the seemingly high returns, why haven't mainstream banks been active players in this growing business of high-cost, short-term credit? If mainstream banks competed more actively in this market, the terms might become more favorable for borrowers. But from another perspective, mainstream banks have been quite active in the market for high-cost, fee-based, short-term credit. After all, many Americans regularly overdraw their checking accounts and pay a fee comparable in size to a payday loan charge for what is, in effect, a short-term loan from the bank.

The Payday Loan Industry

The Supply Side

Payday lending bears some relationship to the century-old practice of "salary buying," a credit transaction in which "a lender would 'buy' at a discount the borrower's next expected wage payment" (Chessin, 2005). The practice of extending credit against a postdated check dates back at least to the Great Depression, according to the Consumer Federation of America (Fox, 2004). As the spread of direct deposit and electronic funds transfer technologies slowed the growth in the demand for check cashing services, some check cashing outlets became direct credit providers, but payday lending was a sideline to their primary business of cashing checks for a fee. The explosive industry growth that began in the 1990s was both demand-induced—as the market for short-term, small-denomination credit soared—and a function of large regional and national payday lending entities entering the market (Consumer Credit Research Foundation, 2004).

At the same time, many mainstream banks stopped making small, unsecured consumer loans, as credit card–based cash advances became the small loan product of choice. With many credit-impaired consumers either ineligible for credit cards, or over their credit limit, payday lenders were there to pick up the slack.

National data on the payday loan industry is not readily available. The estimate cited earlier that the national payday loan market reached $50 billion by 2004 is based on industry estimates, as is the forecast that market maturity will occur at around 25,000 outlets and gross loan fees of around $6.75 billion (Chin, 2004). A wide array of local evidence suggests that the payday loan industry has been growing rapidly in recent years. The number of payday loan outlets in Ohio (1,408) and Oregon (356) doubled over the past four to five years (Johnson, 2005; Graves, 2005), while almost tripling in Arizona (610) (Harris, 2005). Over the past decade, the number of outlets has grown more than twenty-fold in Utah (384) (Davidson, 2005) and ten-fold in Kansas (Gruver, 2005). California went from zero payday lenders in 1996 to 2300 in 2004, with almost 450 new outlets opened in California in 2003 alone (McDonald and Santana, Jr., 2004).

From the standpoint of the quantity of loans made, the growth rate of payday lending is also impressive. Missouri's 2.6 million payday loans in 2004 represented an increase of 30 percent over the previous year (McClure, 2005). From 2000–2003, the number of loans in Washington state grew from 1.8 to 3.0 million (Washington State Department of Financial Institutions, 2003). Between 2002 and 2003, payday originations in Florida increased by an average of 1.9 percent per month and by another 18 percent the following year (Florida Office of Financial Regulation, 2004). In Oregon, between 1998 and 2003, payday loan originations grew by 235 percent to a total of more than 677,000 advances (OSPIRG, 2005), while in Texas, where payday lending was first legalized in 2000, suppliers found a ready market for about a half million loans in 2001, more than 1.0 million in 2002, and 1.8 million in 2003 (Mahon, 2005).

The payday lending industry remains fairly fragmented, although it has experienced some consolidation in recent years driven by economies of scale and the ever-expanding capacities of information and communication technology. More mergers seem to be coming in the payday loan industry, as smaller, independent operators sell to regional and national companies. Some of the factors driving future mergers include a shortage of prime locations, the growing number of legal challenges brought by increasingly aggressive consumer interests, and the growing complexity of state regulatory environments. A few cases in point: in Illinois, five companies own 37 percent of all outlets (Feltner and Williams, 2004); in Florida, 10 companies own 71 percent of all stores and generated 81 percent of all transactions (Florida Office of Financial Regulation, 2004); while in Washington state, four companies account for 55 percent of loan volume (Washington State Department of Financial Institutions, 2003).

Nationally, by the late 1990s, ten chains controlled more than one-third of all payday loan outlets (Gordon, 1998). Currently, six large companies control about 20 percent of all payday lending activities. The nation's largest payday lender is South Carolina-based Advance America, which operates more than 2,600 stores nationwide. The others are: Dallas-based ACE Cash Express Inc., which operates a network of 1,557 stores in 36 states and the District of Columbia (ACE Cash Express, 2001); Check 'n Go, based in Ohio, which has 1,322 payday-loan outlets, up from 1,176 in 2004 (*Cincinnati Business Courier*, 2006); Texas-based Cash America, which has 741 pawn and cash advance locations (Cash America International Inc., 2006); Pennsylvania-based Dollar Financial, which has 725 company-operated financial services stores as part of an international network of 1329 stores (Corporate Financial Information, 2006); and Tennessee-based Check Into Cash, which has over 1200 outlets in more than 30 states, according to the company website.[2] Five of the 13 largest payday lenders now have publicly traded stock (Harris, Konig, and Dempsey, 2005). In June 2006, in an industry first, publicly held ACE Cash Express agreed to a private equity buyout for $420 million, a premium of 14 percent over its then-current share price (Reuters, 2006).

Greater industry concentration will have implications for customers. On the positive side, it should contribute to more consistent store environments and more diverse product menus. In addition, Illinois state regulators report that smaller independent operators are less likely to use computers and more likely to write each loan contract manually, thus increasing the likelihood of errors and unintended violations of truth-in-lending laws (Illinois Department of Financial Institutions, undated).

An analysis of North Carolina lending data in 2001 by Stegman and Faris (2003) also suggests some less benign consequences of large size. North Carolina's "big five" payday lenders seem to feature somewhat shorter-term loans and more repeat borrowing by a larger share of their customer base than other companies. In this study, the percentage of all customers who take out a new loan or roll over an existing loan at least once a month was the second most important determinant of company financial success, next to the total number of customers. Other things equal, each 1 percent increase in customers who borrow at least monthly generated a $1,060 increase in gross outlet revenues in 2000. In 2002, a federal examination of one of the country's biggest payday lenders found that Dollar Financial (partnering with Eagle National Bank) provided incentives to its employees to promote repeat borrowing (U.S. Comptroller of the Currency, 2002, p. 2). Illinois regulators noted in a report on payday lending that,

[2] At ⟨http://www.checkintocash.com/locationsearch.asp⟩, downloaded 5/15/2006.

even when a single licensee has a limited customer base, "if the customer regularly refinances a loan the store may be quite profitable" (Illinois Department of Financial Institutions, undated, p. 6). The business incentive to generate repeated loans can have potentially debilitating consequences for financially fragile families.

Big companies also have more resources for promoting and marketing their products to financially strained populations. For example, Advance America (2004) states, in filings with the Security and Exchange Commission, its belief that supply can create its own demand: "Our mass media advertising campaigns (primarily through television, direct mail and the yellow pages)," the company states, "increase demand for our payday cash advance services," with the campaigns concentrated during back-to-school and holiday seasons. The firm also employs targeted marketing techniques to increase loan demand at its mature locations.

The Demand Side

About 5 percent of the U.S. population has taken out at least one payday loan at some time, according to an analyst for Atlanta-based Stephens Inc., a consulting firm that follows the industry closely. A payday loan primer from an industry-supported think tank reports that more than 24 million Americans—about 10 percent of the adult population—say they are somewhat or very likely to obtain a payday loan (Consumer Credit Research Foundation, 2004). Taken together, these estimates suggest that the industry has thus far penetrated about half its potential market and that substantial unrealized growth opportunities remain.

Most payday loan customers are highly credit-constrained. Nearly all payday loan customers use other types of consumer credit, and relative to all U.S. adults, three times the percentage of payday loan customers are seriously debt burdened and have been denied credit or not given as much credit as they applied for in the last five years (Elliehausen and Lawrence, 2001). Payday loan customers are also about four times more likely than all adults to have filed for bankruptcy. Moreover, in a national survey, over half of current payday loan borrowers report that they already have an outstanding payday loan, which is an issue of policy concern addressed more fully below.

The core demand for payday loans originates from households with a poor credit history, but who also have checking accounts, steady employment, and an annual income under $50,000. For example, Advance America's average customer is 38 years old with a median household income of just over $40,000; in addition, 42 percent are homeowners, and 84 percent are high school graduates (Marketdata Enterprises, Inc., 2005). In Indiana, state regulators report payday loan customers to be in the $25,000 to $30,000 income range; in Illinois the average is $24,000; while borrowers in Wisconsin are even less affluent, with an average income of just $19,000.

Certain groups are more likely to take out payday loans than others. For example, active-duty military personnel are three times more likely than civilians to have taken out a payday loan, due to a combination of demographics, family stage, low pay scale, financial need, and a steady paycheck (Tanik, 2005). One in five active-duty military personnel were payday borrowers in 2005, and payday lending to military members is receiving widespread, high-level attention. According to the Navy Marine Relief Society (NMRS), the problem has begun to affect military preparedness because "Marines who are preoccupied with their financial troubles are distracted from their main obligations," which is why NMRS has begun to pay off service member's payday loan debts (Rogers, 2006). To protect military borrowers, Congress passed a measure banning payday loans to service personnel on active duty and their families effective October 1, 2007, and capped interest rates on other unsecured consumer loans at a 36 percent annual percentage rate, which is the same maximum rate specified in the small loan laws of many states (Center for Responsible Lending, undated).

Although little national data regarding racial and ethnic differences in either loan demand or locational preferences of payday lenders is available, a 2001 survey of low-income families in Charlotte (North Carolina's biggest city and a national banking center) estimated that African Americans were about twice as likely to have borrowed from a payday lender in a two-year period as whites (10 percent versus 5 percent), and that, after controlling for a wide range of socioeconomic characteristics, blacks were five times more likely than whites to take out multiple payday loans (Stegman and Faris, 2001, 2005.) In terms of geography, payday lenders in Charlotte, North Carolina, favored working-class neighborhoods rather than the city's poorest communities. There were more than five outlets per 10,000 households in neighborhoods where the median income was between \$20,000 and \$40,000. That compared with 3.4 per 10,000 households in neighborhoods where the median income was less than \$20,000. These payday lending outlets also disproportionately favored high-minority neighborhoods. Relative to population, there were one-third as many banking offices and more than four times as many check cashing offices in Charlotte neighborhoods that were at least 70 percent minority as in neighborhoods that were less than 10 percent minority (Kolb, 1999).

Throughout North Carolina, according to the Center for Responsible Lending, a Durham-based advocacy organization, "African-American neighborhoods have three times as many payday lending stores per capita as white neighborhoods, and this disparity increases as the proportion of African-Americans in a neighborhood increases. Moreover, these large disparities persist even when neighborhood characteristics of income, homeownership, poverty, unemployment and other characteristics are taken into account" (King, Li, Davis, and Ernst, 2005).

North Carolina is not the only state where this issue has arisen. Texas payday lenders also tend to concentrate in counties with high proportions of minority residents and poverty (Mahon, 2005). According to one newspaper tally, in Cameron County, where 85 percent of the 335,227 residents are minorities and one-third live in poverty—the county has 115 payday lending stores and just 64 bank branches. By contrast, suburban Collin County (northeast of Dallas), where only 24 percent of the 491,675 residents are minorities and only 5 percent are poor, there are 30 payday lending outlets and 155 banking offices.

Simple Fix or Nuclear Option?

Suggested remedies for the alleged problems of payday lending range from relatively simple fixes, such as stepped-up enforcement efforts to eliminate violations of federal truth-in-lending regulations which require clear disclosure of key terms of consumer credit transactions and all costs, with all fees folded into an all-inclusive annual percentage rate (Encyclopedia of Everyday Law, undated); to stepped-up oversight by regulators; to fixes involving more direct intervention in the marketplace, such as the use of zoning laws to influence firm location decisions; all the way to strict regulations requiring fundamental changes in the industry's core business model that, at the extreme, might threaten its very existence (Butler and Park, 2005, p. 121; Flannery and Samolyk, 2005, p. 4).

Using zoning powers to prevent payday lenders from clustering in or near residential neighborhoods is being tried in Arizona—more for its nuisance value than anything else. For example, South Tucson requires new payday-loan businesses to be a quarter of a mile from other payday-loan shops and 500 feet from homes or residentially zoned properties, while a pending Phoenix law would require payday outlets to be at least 1,000 feet from each other, similar to distance restrictions placed on sexually-oriented businesses (Bell, 2005; Alonzo-Dunsmore, 2005). Because chronic borrowers patronize more than one payday lender at a time, borrowing from one to pay off another, the limitations on clustering may decrease customer convenience, and make it more difficult for some lenders to secure prime sites, but that's about it. It is also possible that by conferring market advantages to existing businesses in convenient locations, and keeping out newcomers, such regulations may discourage price competition among payday lenders, which is not a desirable outcome. By and large, local officials recognize that they can't change basic industry practices through zoning, but frustrated by their inability to convince state lawmakers to take more restrictive actions, they are trying to use the legal power available to them (Alonzo-Dunsmoor, 2005).

Frustration with state inaction led the Common Council of Wauwatosa, Wisconsin, a Milwaukee suburb, to try using land use controls to thwart local growth of payday lending. In September 2006, the council decided to impose a one-year moratorium on check-cashing, payday loan, and similar businesses in some locations while they considered a measure to restrict them to certain locations. "It's exciting to see these communities take this into their own hands," said Carrie Templeton, of the State Department of Financial Institutions. "We need some momentum to get the Legislature to enact reasonable protections for consumers" (Johnson, 2006).

Efforts to distance payday lenders from clustering around military bases have also occurred, especially since the Department of Defense has requested that governors and state legislators help to protect service members from payday lending. Four states enacted new protections for members of the military in 2005, including a ban on lending in areas declared off-limits by a military base commander (Virginia), a prohibition on garnishing military wages or taking collection measures when the service member is on active duty (Illinois and Washington) or deployed to a combat area (Illinois, Texas, Virginia, and Washington), or is a member of the National Guard and called up to active duty (Texas) (Center for Responsible Lending, 2005, p. 3).

Of course, the preferred policy choices will vary according to whether payday loans are viewed as a tolerable high-cost form of emergency short-term credit, or whether they are viewed as a loan at triple-digit annual interest rates. Concern over chronic indebtedness from repeat borrowing trumps other public policy concerns with payday lending by a wide margin. The strongest critics say that payday loans are the credit market's equivalent of crack cocaine; a highly addictive source of easy money that hooks the unwary consumer into a perpetual cycle of debt. Or as one member of the Arizona state legislature said, "[T]he only difference between payday-loan centers and loan sharks is that payday lenders don't break your legs" (Harris, Konig, and Dempsey, 2005).

Empirical evidence of the rollover phenomenon and serial borrowing through payday loans abounds. According to one study, about 40 percent of payday loan customers nationally rolled over more than five loans in the preceding 12 months, including 10 percent who renewed an existing loan 14 or more times (Elliehausen and Lawrence, 2001). In the course of site examinations of licensed lenders, Illinois regulators found evidence of "customers who were borrowing continuously for over a year on their original loan" (Illinois Department of Financial Institutions, undated, p. 8). More recent data from Florida show the same trend: the average number of transactions per customer between October 2004 and September 2005 was 7.9, with more than a quarter of all customers taking out twelve or more advances in a single year (Veritec Solutions, 2005a). In Oklahoma, the average number of transactions per borrower between October 2004 and September 2005 was 9.4. Approximately 26.8 percent of customers took out twelve or more loans during the period, accounting for 61.7 percent of total transactions (Veritec Solutions, 2005b). A 2004 survey in Portland, Oregon, found that about three out of every four payday loan customers were unable to repay their loan when it became due (OSPIRG, 2005).

These kinds of statistics served as the raw material for the estimate by the Center for Responsible Lending (which is part of the Center for Community Self-Help, a community development lender based in Durham, North Carolina), that this kind of debt trap costs families $3.4 billion annually (Ernst, Farris, and King, 2004). Their cost estimate is based on an assumption (p. 7) that "if payday lending really is set up for the occasional emergency as payday lenders claim, allowing one of these to occur every quarter should be sufficient to meet the credit needs of these borrowers. Accordingly, we chose five or more loans as the dividing line above which borrowers should be considered harmed by repeated payday loans."

Most reforms of payday lending revolve around efforts to reduce serial borrowing. Twenty states now limit the number of advances a borrower can have outstanding at any one time. Thirty-one states limit rollovers. Seven states provide for mandatory cooling-off periods between loans that range from the next business day after two consecutive loans are repaid in Alabama, to seven days after five consecutive loans are repaid in Indiana. Twenty-eight states prohibit use of criminal charges to encourage repayment of payday loans. The National Council of State Legislatures (NCSL) provides a survey of state payday loan laws (National Council of State Legislatures, 2006).

Other attempts to limit serial borrowing are more complex. For example, New Mexico state law now limits consumers to just two back-to-back renewals at a maximum fee of $15.50 per $100 advanced, with the maximum advance set at a total payment not exceeding 25 percent of the borrower's gross monthly income (Office of the Governor, State of New Mexico, 2006).

Short of banning payday lending altogether, Illinois has enacted the most restrictive reform measures in the country. Similar to New Mexico, Illinois caps payday loan fees at $15.50 per $100, and also caps total loan amounts that a borrower may have outstanding from all lenders at any one time at $1,000 or 25 percent of the borrower's monthly salary, whichever is less. Illinois borrowers may also opt for a repayment plan rather than having to repay the loan all at once, thus converting a payday advance into an installment loan. The Illinois law also requires a 14-day cooling off period after completion of a payment plan before a borrower can take out another loan. Illinois also joins Florida and Oklahoma in requiring lenders to report customer loan information to a central database and to consult the database before making a new loan. For the text of the Illinois law, see Citizen Action Illinois (2005). Because of the high prevalence of serial borrowing from multiple lenders, any serious regulatory effort to limit chronic borrowing should include such a database, yet only a few states currently require it.

"Nuclear option" type regulatory fixes would essentially wipe out payday lending as we now know it. One approach here would apply existing usury laws to payday loans, which typically cap interest rates at an annual percentage rate of 60 percent or less. This is what Georgia did in 2004, with repeated violators subject to felony charges, large fines, and prison time (Center for Policy Alternatives, 2006).

Using legal reasoning that the payday lending business is based on a fraudulent premise, North Carolina officials invoked the state's bad check law to shut down the payday loan industry (Moss, 2000). The law prohibits "any person, firm, or corporation to solicit or to aid or abet any person writing a check knowing or having reasonable grounds for believing at the time of the soliciting that the marker or drawer of the check or draft has not sufficient funds on deposit in, or credit with the bank or depository with which to pay the check or draft upon presentation" (Fox, 2005).

The political clout of the payday loan industry in statehouses across the country is reflected in the rising number of states that explicitly authorize payday lending, from 23 plus the District of Columbia in 2000 to 38 in 2005. However, more recent political sentiment seems to be moving against the industry. According to data from National Council of State Legislatures (2005), of 66 payday loan measures introduced in 27 state legislatures in 2005, 18 laws were enacted in 13 states, and several of the laws were opposed by the industry. For example, Delaware exempted payday loans from the state's civil bad check statute, thereby denying lenders bounced check fees when payday loans fail to clear the customer's account. Louisiana law now prohibits payday lenders from taking any direct or indirect interest in property in the event that a payday loan is not repaid. Montana law provides a one-day right of rescission to payday loan borrowers and allows the state to deny a license or license renewal to those applying to be payday lenders if they have a criminal history. In summer 2006, the governor of Oregon announced a new campaign to discourage patronage at payday lenders by installing a 1-800 hotline and website promoting payday loan alternatives. "The hotline can match consumers with credit unions they are eligible to join that offer payday loan alternatives" (Salem-News.com, 2006).

Regulators Force Evolution of Payday Loan Industry Business Model

Controversy has surrounded payday lending ever since its emergence as an important player in the consumer credit market, and in a kind of multidimensional chess game, the industry has challenged each new wave of regulations and, when unsuccessful, modified its business model accordingly.

The Rent-a-Bank Model

In the late 1990s, many states began to clamp down on high loan fees, which precipitated a dramatic change in the payday loan industry's predominant business model. In an effort to circumvent state fee caps, payday loan companies began partnering with out-of-state national banks that are allowed under federal banking laws to export the interest rate of their home state into another state (Mortgage Bankers Association of America, 2000). As Snarr (2002, p. 3) explains: "In 1978, the U.S. Supreme Court upheld the constitutionality of the National Bank Act, which permits nationally chartered banks to charge their highest home-state interest rates in any state in which they operate. This allows banks to ignore local usury laws and other state interest rate caps, and is why many banks have established their home charters in states without usury laws like Delaware and South Dakota." The Depository Institutions and Deregulation and Monetary Control Act of 1980 allows state-chartered banks and other financial institutions accepting federally insured deposits to do the same. Thus, when payday lenders began partnering with banks, payday loans become "bank loans," and thus not subject to state-imposed fee caps or usury laws.

Under pressure from states and consumer advocates, federal banking regulators began to clamp down on what became known as the "rent-a-bank" model of payday lending, citing safety and soundness concerns. In November 2000, both the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) issued advisories to their regulated institutions that promised closer scrutiny and additional examinations of banks and thrifts that were partnering with payday loan companies (Bair, 2005, p. 14; Federal Deposit Insurance Corporation, 2000).

In July 2003, the FDIC issued its own guidelines for state-chartered banks engaged with payday lenders requiring, among other things, "significantly higher levels of capital, perhaps as high as 100 percent of the loans outstanding" and that payday loan portfolios should be classified as substandard for regulatory reporting, risk management, and loan loss reserving purposes. With at least 11 of the 13 largest payday loan companies in the industry having adopted the rent-a-bank model for some portion of their lending, in March 2005 the FDIC further tightened its guidance by effectively prohibiting its regulated banks from making more than six payday loans a year to a single borrower. Given the importance of borrowers receiving repeated loans, to the payday lending business model, this rule rendered the rent-a-bank model obsolete (Fox, 2004, p. 1; Bair, 2005, p. 15).

Internet Payday Lending

Payday lenders have been experimenting with online products and using the Internet as a cost-effective delivery channel, although this channel has yet to achieve the popularity of either the stand-alone payday lender or the rent-a-bank model. Dennis Telzrow, an analyst for Stephens, Inc., an investment bank that follows the industry, has estimated Internet payday loan revenues at $500 million a year, while a major Internet lender, Pioneer Financial Services, Inc. reported to the SEC that its lending increased 59 percent in fiscal 2005, from $84.2 million to $134.1 million (Department of Defense, 2006). While at least one payday lender has gone online, betting that "Internet-savvy borrowers who are more educated, are better credit risks than retail customers, the more common explanation for the growth of Internet lending is that it is just another way for lenders to take advantage of lax regulations in their home states and make loans without complying with licensing requirements or state protections in the borrower's home state" (Berquist, 2005; see also Fox and Petrini, 2004, p. 4).

A cursory review of the trade literature seems to support the latter motive. In Massachusetts, where payday lending is illegal, banking regulators issued more than 90 cease-and-desist orders to out-of-state payday lenders who were using the Internet to make loans in that state (Mohl, 2005). In May 2006, the Massachusetts Office of Consumer Affairs' Division of Banks issued 48 similar orders against out-of-state payday lenders who were marketing illegal loans to Massachusetts consumers through the Boston Craigslist website and in the *Boston Herald* (Commonwealth of Massachusetts Office of Consumer Affairs and Business Regulation, 2006).

Finally, shortly after the North Carolina payday lending law was allowed to expire in September 2001 (North Carolina General Statutes, 1997), a local payday lender reopened its doors, offering Internet service to customers, who got an immediate "rebate" of up to $500 in return for agreeing to pay periodic fees of $40 to $100 per month for a few hours of Internet access at the provider's office computers for a few hours a week. A local court applied the "if it smells like a duck and walks like a duck" rule, shutting this business down as an illegal payday lending service (NBC-17, 2005).

The Latest Iterations: The Credit Services Organization and Participation Fees

With their bank partnerships checkmated by federal regulators, in a through-the-looking-glass metamorphosis, payday lending companies in Texas have begun to register their businesses under a law originally designed for companies that improve a buyer's credit record, or provide credit repair services for financially stressed consumers. So-called Credit Service Organizations (CSOs), authorized under the Texas Finance Code, allow payday lenders to serve as loan brokers while not being subject to any federal or state banking regulations; in this case, the brokered loans come from third-party lenders created by the payday loan company specifically for the purpose of funding the CSO company's payday loans. On June 30, 2006, for example, Advance America announced its intention to convert its 208 payday loan centers in Texas to CSOs, and created an independent limited liability company with $20 million to loan out (Kix, 2005). In rapid order, First Cash Financial Services of Arlington, with more than 300 payday lending stores in 11 states and Mexico, made similar plans, as did Cash America, and EZCORP of Austin, with its 177 payday lending storefronts.

Meyers (2005) explains the credit service organizations' business model in this way:

> A customer who enters a payday lending store will fill out the CSO paperwork and receive their loan, much as they did before under the PDL [payday loan] system. However, the money for this loan will not come from a third-party bank, but from what is called a third-party unregistered lender under Texas law. In the case of Advance America, this unregistered lender is a separate LLC [limited liability company] with $20 million to loan out. This LLC does not employ, nor does it consist of, any Advance America employees.
>
> Advance America collects three fees from the customer: (1) A referral fee, for referring the customer to the LLC that will fund the loan, of $20 per $100 borrowed; (2) an application fee for filling out the CSO paperwork, which is about $10 per $100 borrowed, and (3) the interest for the loan, which state law caps at $10 per $100 borrowed. The payday lender or CSO keeps the referral fee; the other two fees go to the LLC.
>
> Who carries the default risk? The payday lender, leaving the LLC free and clear of any risk. And the payday lender doesn't have much to worry about, either. The ultimate default rate is 2% of gross loan receivables.

An even more recent innovation than the Credit Services Organization is for the payday lender to charge participation fees for the right to draw down a line of credit that would be made available to the customer at a low interest rate that falls within existing state usury laws or fee caps. An example is the Advance America Choice-Line of Credit that the company introduced in Pennsylvania. This product provides customers access to up to a $500 line of credit for a monthly participation fee of $150, plus interest on outstanding loan balances at a 6 percent annual percentage rate (Sabatini, 2006). When the participation fee is factored into total finance charges, the resulting annual percentage rate would approximate traditional payday loan fees. No federal or state law has yet to incorporate participation fees into their payday loan regulatory structures.

There do not appear to be any studies of the financial impacts of these mounting regulatory attacks on payday lending companies, or whether these industry countermeasures will prove equally profitable as the original business model. However, lagging stock prices for some publicly traded payday loan companies may be signaling some investor doubt about long-term prospects. Despite continued strong financial performance and two recent stock buy-backs totaling $150 million, Advance America's share price fell by 44 percent between January 21, 2005, and July 27, 2006 (Werner, 2006).

Payday Lending and Banks as Fee-Based Businesses

Given the continuing strong demand for payday loans, why have so few mainstream banks and thrifts created products aimed at competing in this market? Trade publications have speculated that the reasons might include reputation risk, and also that many small loans will necessitate high fixed costs and require higher interest rates than are allowed under most state usury laws. But a growing body of empirical evidence suggests an additional reason: the rise of fee-based banking. Heightened competition, narrowing net interest margins, and deregulation, have led to demand-induced changes in the mix of bank products and services over the past 20 years to those which generate fee income, including insurance, mutual funds, and other investment products (Ludwig, 1996). Since the beginning of the 1980s, noninterest income has grown at roughly twice the rate of net interest income, and now accounts for more than half of all bank revenues, according to the American Bankers Association (undated). This transition was hastened by a 1996 Supreme Court ruling in *Smiley v. Citibank* (517 U.S. 735) which established that fees were in essence "interest" and therefore fell under the same guidelines that permitted national and state chartered banks to export their home-state interest rates. According to Tamara Draut (2006) of the nonprofit organization DEMOS, "before *Smiley*, most states limited credit card late fees to $10 to $15; today, the top ten issuers charge $35 to $39. As banks have become fee-based businesses, their bottom lines are better served by levying bounced check and overdraft fees on the payday loan customer base than they would be by undercutting payday lenders with lower cost, short-term unsecured loan products.

In 2005, for example, "banks, thrifts and credit unions collected a record $37.8 billion in service charges on accounts, more than double what they got in 1994" (Chu, 2005). One of the newest and most profitable charges is the "courtesy overdraft fee," now offered by more than 80 percent of all big banks, which costs checking account customers more than $10 billion a year (Duby, Halperin, and James, 2005). Between 1994 and 1999, bank overdraft fees increased by 17 percent (Peterson, 2004). These fees now extend to withdrawals from automatic teller machines and debit card purchases, and a third of all banks charge additional fees if overdrafts aren't paid in an average of five days (Consumer Federation of America, 2005). Because banks automatically subtract the overdrawn amount plus the overdraft fees from the next deposit, while consumers are not notified about the deductions, many consumers will not even be aware of the fee unless or until they check their balance carefully (Chu, 2005).

Because overdraft fees are classified as fees and not interest-bearing loans by financial regulators, these fees neither fall under usury laws nor federal truth-in-lending regulations. If they did, they would translate into triple and quadruple-digit annual interest rates, just as high or higher than many payday loan rates (Center for Responsible Lending, 2003; Thomson, 2005).

Some banks actually apply the same marketing approach to overdraft services, as if they were payday lenders. For example, here is text from a bank advertisement (as quoted in Consumer Federation of America, 2003):

> Access your Paycheck Before you have it! Sound too good to be true? Well it isn't, now start writing checks before you get paid without the worry of returned checks. Have you ever been shopping on the weekend and find a must-have item, but don't have the money in your checking account to cover your check? Have you ever had unplanned expenses between paydays? There is no need to worry! With [bounce protection], you will be covered without the embarrassment of a returned check.

One implication of the transition to fee-based banking is that whereas banks used to ignore customers with poor credit records altogether, or perhaps hold them on a tight leash, they now view such customers as profit centers. A similar dynamic operates in credit card markets, where a *Wall Street Journal* story noted that instead of cutting "people off as bad credit risks, banks are letting them spend—and then hitting them with larger and larger penalties" (Pacelle, 2004). Indeed, many chronic payday borrowers have already run out the string on their credit card limits. Of course, the interest rates on most credit cards calculated at an annual rate are significantly lower than those on the typical payday loan. However, because average balances on credit card accounts are so much higher—an average of $8,400 that takes about 43 months to pay off, according to responses from a national survey of households with credit card debt whose income profile is similar to that of the payday loan customer profile (Draut, 2006)—the cost of credit card interest payments and added late fees to family finances and to their ability to work themselves out of debt is at least as great as with payday loans.

A Counterexample: A Large Financial Institution with an Affordable Payday Loan Product

Can large financial institutions create a less costly, yet profitable consumer credit product that could compete head-to-head with payday loans? While the jury is still out on this issue, it is worth noting that with few exceptions, the locus of product innovation is centered in mission-driven credit unions, and not in commercial banks or thrifts. For the last five years, North Carolina State Employee's Credit Union (SECU)—the second-largest credit union in the country, with 1.25 million members and assets of more than $12.7 billion—has offered such a product on a large scale. The credit union first learned from branch managers' analyses of checks clearing through their system that thousands of credit union members were reliant on payday loans to make it through the month. In January 2001, the credit union modified an existing open-end line of consumer credit and created the Salary Advance Loan (SALO), a loan product that helps credit union members to bridge the gap between paydays and also to build savings. Since then, nearly 53,000 SECU members have taken out more than one million SALO advances totaling nearly $400 million, as shown in Table 1. The product has enjoyed steady growth. The typical monthly volume of SALO advances is roughly $12–13 million. This information and all data about SALO are from materials and information provided to the author by Philip E. Greer of the North Carolina State Employees Credit Union.

Any member of the North Carolina State Employees Credit Union whose paycheck is on direct deposit, is not in bankruptcy, and has not caused any previous losses to the credit union, is eligible to request a SALO advance up to a maximum of $500. The advance is repaid automatically on the member's next payday by an automated transfer from the deposit account to the loan, which helps to keep costs of the loans low for the credit union. SALO has a current annual percentage rate of 12 percent, or a maximum of about $5 a month on the maximum advance, which is about one-fortieth of the cost of a typical payday loan.

The typical credit SALO customer has an income of less than $25,000 a year, and credit union share deposit account balances averaging less than $150. Not surprisingly, the combination of low price and high need has led about two-thirds of all SALO customers to take out advances every month of the year—the equivalent of 11 rollovers in the conventional payday loan market. In September 2005, about 80 percent of SALO customers had a credit score of less than 585, which places them squarely in the subprime credit risk category. By contrast, just 15 percent of the U.S. population has a credit score of less than 600, and just 7 percent have a credit score under 550 (MyFICO, undated).

The experience of the North Carolina State Employee's Credit Union (SECU) with the SALO shows that large institutions can market more affordable payday loan products to high-risk customers at interest rates that are a small fraction of prevailing payday loan rates. SECU has earned a total of about $2.5 million in interest income since SALO's inception, experiencing a net loss of about $1 million

Table 1
Overview of North Carolina State Employees Credit Union (SECU) Salary Advance Loan (SALO) Product
(since inception in January 2001 through June 30, 2005)

Total SALO customers	52,591
Total SALO advances since inception	1,050,000
SALO customer average share account balance	$136
Percent customers taking monthly advance	65%
Average loan amount	$380
Average length of advance	28 days
Total funds loaned since inception	$397,497,122
Total interest earned since inception	$2,496,905
Total interest earned as percent of total dollars advanced	0.63%
Percent 60 days delinquent	1.40%
Percent 90 days delinquent	0.65%
2001–2004 annualized charge-offs as percent loaned	0.27%
2004 charge-offs as percent loaned	0.23%
2005 annualized charge-offs (percent)	0.24%
Recoveries since inception as percent of total charge-offs	16.50%
Number of June 2005 SALO advances	32,910

Source: North Carolina State Employees Credit Union

in principal (on $400 million volume), resulting in a net income of about $1.5 million. Despite the credit-impaired customer base, delinquency rates have been quite modest, with annual gross charge-offs averaging about 0.27 percent of loan volume. The basic economics of the SALO program are summarized in Table 2. Deducting aggregate program costs from gross interest income leaves SECU with a net profit margin of almost 7 percentage points.

In March 2003, the North Carolina State Employee's Credit Union modified the SALO program by requiring that 5 percent of every SALO be deposited into a new member-owned special savings account. The hope was that with sufficient accumulation of savings, over time the member will be able to make a withdrawal rather than seek another SALO advance. These accounts presently total $7.2 million, with some members having accumulated balances of $1,000 or more. The money in the account

Table 2
Basic Economics of SALO Advance Program

Historical Interest Rate	12.00%
Minus:	
Loan Losses	(0.27%)
Cost of Funds	(2.75%)
SECU Operating Costs	(2.00%)
Retained Earnings	6.98%

belongs to the member, but a member who makes a withdrawal becomes ineligible for a SALO advance for the following six months. According to SECU officials, the SALO savings requirement has been well received. For many members, this account was their first experience with saving on a regular basis; even though, at least initially, growing balances are associated with more frequent borrowing.

Of course, mainstream banks, have a different mix of customers, a different relationship to their customers, and different pressures in financial markets compared with credit unions. However, there is lots of space to create a less-expensive payday loan product between the 12 percent annual percentage rate SALO, or the annual rates of 16–28 percent charged by most credit cards, and the triple-digit annual interest rates for most payday loans. In fact, in 2005, the average charge-off rates for credit card issuers was 5.15 percent, higher than loss rates (as a percent of loan volume) for all but one of the following publicly traded payday loan companies: ACE Cash Express (4.5 percent), Advance America (4 percent); Cash America (4.6 percent), EZ Pawn (6.2 percent), First Cash Financial Services (3.6 percent), and QC Financial (4.2 percent) (Chessin, 2005, pp. 408, 387–423; payday industry loss data from email from Jean Ann Fox on a payday loan listserv, 4/13/2006). However, as long as mainstream banks can continue what is in effect their own form of payday lending—like charging fees for "bounce protection" and overdrafts—they have little incentive to compete in the market for lower-priced payday loans.

What Should Policymakers Do?

A recent national survey of American adults shows that the public is more worried about falling into debt, particularly through medical bills, than about being a victim of a terrorist attack or natural disaster. In addition, only half of survey respondents were able to pay off their entire credit card bill every month (Greenberg Quinlan Rosner and Public Opinion Strategies, July 2006). The sharp rise in payday lending is both a symptom and a cause of these concerns over credit.

The rise and phenomenal growth of the payday loan industry required both strong market demand for such loans and a compliant regulatory system that exempted the fees that lenders charge for holding postdated checks from state usury laws and interest rate caps. This regulatory climate also allows "bounce protection" and assorted other bank fees and penalties from which banks profit so handsomely, and these profits discourage mainstream banks from under-pricing payday lenders in a head-to-head competition. Therefore, if the desired result is more programs like the Salary Advance Loan provided by the North Carolina State Employee's Credit Union, a first step would be for policymakers and regulators to bring all fees and charges associated with the provision of short-term consumer credit by banks and nondepositories alike under a consistent set of disclosure and usury regulations (Consumer Federation of America, 2003). In setting these rules, policymakers and regulators must be mindful that setting caps on fees or setting implied interest rates arbitrarily low could easily curtail or eliminate the flow of credit to the high-risk borrowers who need it most.

A second recommendation is that policymakers and regulators should focus more of their attention on ways to limit rollovers and back-to-back renewals of payday loans, rather than focusing on the price of a single short-term advance.

Third, research and evidence on payday lending need to catch up with anecdotes and polarized arguments. We have almost no empirical evidence on how some of the main policy options would affect the demand, price, and use of short-term credit. This is true for zoning regulations to lessen customer convenience and access; the lengthening of minimum payback periods; the introduction of an installment option; limits on rollovers and renewals; and the "nuclear options" that would effectively end payday lending. It matters whether a policy affects the price or just the convenience of accessing credit; whether it forces consumers to drive across state borders or drives them underground to satisfy their credit needs. Other things equal, I prefer to keep the provision of credit to all consumers in the mainstream economy where competition is open and where market exchanges can be observed and, if necessary, regulated.

Finally, one cannot study payday lending and fee-based banking without confronting America's addiction to credit. As former treasury official Sheila Bair (2005, p. 38) has noted, "[T]he escalating demand for the [payday loan] product reflects the woeful inability of millions of Americans to effectively manage their finances and accumulate savings." For example, one national survey found that only 27 percent knew that credit scores measure credit risk, just over half understood that maxing out a credit card would lower their credit scores; and, only 20 percent knew that just making minimum payments on credit cards will do likewise (Common Dreams Newswire, 2005). Those with low incomes and the least education were also the least likely to understand credit scores and know their own scores. As long as the demand for short-term credit remains high among high-risk, low-income borrowers, it is unlikely that the payday lending problem will be entirely solved by measures focused on the firms supplying such loans.

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